Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-8315-98
[redacted]

date: JAN 29 1999

to: Examination Division, [redacted]
ATTN: [redacted]

from: Associate District Counsel, [redacted]

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subject: [redacted]

This memorandum responds to your request for advice concerning the treatment of a transaction in which [redacted] contributed assets to a partnership and immediately sold the partnership interest received in exchange for the contribution.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether [redacted] realized a gain on the sale of its partnership interest in [redacted] in the amount reported on its [redacted] U.S. Corporation Income Tax Return, Form 1120.

2. Whether [redacted] realized a loss in the amount of $[redacted] on the sale of [redacted] located in [redacted] to [redacted].

CONCLUSIONS

1. No. We believe that I.R.C. § 707(a)(2)(B) may apply to the contribution of the restaurants located in [redacted] and [redacted] to [redacted]. We have recommended that the Service obtain additional information in support of this conclusion.

2. Yes. The Taxpayer should have reported a loss of $[redacted] ($[redacted] - [redacted]) and a bad deduction of $[redacted] for [redacted]. The net effect of reporting the transactions in this fashion is the same. However, the Service may wish to evaluate whether the Taxpayer is entitled to a bad deduction in [redacted]. By doing so, the Service could shift a portion of the loss to [redacted].

We have recommended that the Service obtain additional information for the purpose of determining whether the Taxpayer sold [redacted] percent of the assets of the restaurants located in [redacted] or sold [redacted] percent of the assets.

In addition, we examined two other approaches but did not find them to be feasible.

Caution: The issues raised by the Service involve the amount and character of contributions, the amount and character of distributions, and transactions to which I.R.C. § 707(a) apply. These items are partnership items as defined in I.R.C. § 6231(a)(3). Treas. Reg. § 301.6231(a)(3)-1(a)(4). As a consequence, they must be determined in a partnership proceeding. I.R.C. § 6221. The Service, therefore, should open TEFRA proceedings with respect to [redacted] and [redacted].

FACTS

I. PARTIES

[redacted] (the "Taxpayer") is a publicly held corporation organized under the laws of Delaware and engaged in the restaurant business. The Taxpayer is recognized for its [redacted] restaurants.

[redacted] ("[redacted]")[1] is a Delaware corporation wholly-owned by the Taxpayer and incorporated in or about [redacted] for the purpose of acquiring certain rights in the [redacted] restaurants.

[redacted][2] ("[redacted]") is a Delaware corporation owned equally by [redacted] ("[redacted]") and [redacted] ("[redacted]"), the originators of the [redacted] concept.

[redacted] ("[redacted]") is a Delaware limited partnership formed in [redacted]. [redacted] owns a [redacted] percent general partnership interest in [redacted], while approximately [redacted] individuals together own a [redacted] percent limited partnership interest.

[redacted] ("[redacted]") is a Delaware limited partnership formed on [redacted], for the purpose of owning and operating [redacted] restaurants located in [redacted] and [redacted].

[redacted] ("[redacted]") is a Delaware limited partnership formed on [redacted], for the purpose of holding an interest in [redacted]. [redacted] is owned as follows:

Partner	Interest	Percentage
[redacted]	General Partner	[redacted]%
[redacted]	Limited Partner	[redacted]%

[redacted] is a Delaware corporation owned equally by [redacted] and [redacted].

[redacted] ("[redacted]") was a Delaware limited partnership formed on [redacted], for the purpose of owning and operating the [redacted] restaurants located in [redacted]. [redacted] was owned as follows:

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[1] [redacted] changed its name to [redacted] on [redacted] and then changed its name back to [redacted] in [redacted].

[2] [redacted] began as a [redacted] corporation incorporated as [redacted]. [redacted] changed its name from [redacted] on [redacted], the same day as [redacted] changed its name to [redacted] reincorporated in Delaware in [redacted].

Partner	Interest	Percentage
[redacted]	General Partner	[redacted]%
	Class B Limited Partner	[redacted]%
[redacted]	Class A Limited Partner	[redacted]%

[redacted] dissolved on [redacted].

[redacted] ("[redacted]") is a Delaware limited partnership formed on [redacted], for the purpose of holding an interest in [redacted]. [redacted] is owned as follows:

Partner	Interest	Percentage
[redacted]	General Partner	[redacted]%
[redacted]	Limited Partner	[redacted]%

As stated above, [redacted] is a Delaware corporation owned equally by [redacted] and [redacted].

II. BACKGROUND

The Taxpayer and its subsidiaries (including [redacted]) file a consolidated return.

In the late [redacted]'s, the Taxpayer sought to expand its business to include restaurants that differed but complemented its [redacted] restaurants. Specifically, the Taxpayer became interested in a chain of [redacted] restaurants named "[redacted]" or "[redacted]."

In [redacted], [redacted] purchased development rights and a license to use the [redacted] name in [redacted] and [redacted] from [redacted]. At the same time, the Taxpayer entered an operating agreement with [redacted] to operate existing [redacted] restaurants in [redacted] and [redacted].

In [redacted], [redacted] and [redacted] entered into an Amended and Restated Area Development and License Agreement ("Restated Development Agreement") in which [redacted] paid $[redacted] to obtain the exclusive right and license to establish and operate [redacted] restaurants throughout the world for a term of [redacted] years. [redacted] also was required to pay a quarterly royalty fee equal to [redacted] percent of its gross sales from its [redacted] restaurants and to develop [redacted] new [redacted] restaurants for each of the first [redacted] years of the Restated Development Agreement.

By late [redacted], [redacted] owned and operated [redacted] restaurants, [redacted] in [redacted] (the "[redacted] Restaurants"), [redacted] in [redacted] (the "[redacted] Restaurants"), and [redacted] in [redacted] (the "[redacted] Restaurants").

At this time, the Taxpayer adopted a plan to focus on the operations and long-term success of the core [redacted] business. The plan involved the selling of the [redacted] restaurants and the development of the [redacted] restaurants.

The Taxpayer states that the [redacted] restaurants were widely marketed for sale but that it received a weak response from interested buyers and the investment banking community. See letter dated [redacted], from [redacted], the Taxpayer's representative to the Service. The Taxpayer attributes the weak response to the poor performance of the [redacted] concept outside of [redacted] and the restrictions placed on the Taxpayer by the license and management agreements. Id. The Taxpayer then states, "As negotiations continued, it became apparent that [redacted], the original licensor, was the logical buyer." Id.

The Taxpayer approached [redacted] and [redacted] as potential purchasers of [redacted]'s [redacted] restaurants. [redacted] and [redacted] agreed to repurchase from [redacted] the development and licensing rights in the [redacted] restaurants and to purchase the assets of the [redacted], [redacted], and [redacted] Restaurants. [redacted] and [redacted], however, wanted to separate the [redacted] Restaurants from the [redacted] and [redacted] Restaurants, because the [redacted] Restaurants were not successful. As a consequence, the transaction was divided into two parts.

As vice-president of [redacted], [redacted] outlined the terms of the agreement in a letter dated [redacted] (the "Letter of Intent"). The basic terms are restated below:

1. [redacted], or its general partner, [redacted] will form two new entities, named "[redacted]" and "[redacted]." The type of entity will be determined at a later date.

2. [redacted] will buy the [redacted] and [redacted] Restaurants from [redacted] for a promissory note of $[redacted].

3. [redacted] will buy the [redacted] Restaurants from [redacted] for a promissory note of $[redacted].

4. [redacted] will receive an equity interest of [redacted] percent in each of [redacted] and [redacted].

5. The promissory notes each will bear interest at percent per annum and will be secured by the restaurant assets sold. Principal and interest will be amortized over years with a balloon payment after years.

6. The Taxpayer is prohibited from soliciting offers and responding to inquiries for the sale of or the and Restaurants. The Taxpayer, however, may solicit offers and respond to inquiries for the sale of the Restaurants.

7. In lieu of the proposed asset purchase, may elect to purchase the stock of .

The Taxpayer agreed to and accepted these terms on .

On , the Taxpayer's board of directors approved the following transactions:

1. sale of the Restaurants to a new limited partnership, , for a $ promissory note plus a percent interest in .

2. contribution of the and Restaurants to a new limited partnership, , for a percent limited partner interest, followed by the sale of a % limited partner interest in to for a $ promissory note.

See minutes of the Taxpayer's board of directors dated . On the Taxpayer's board of directors ratified and confirmed the agreements underlying the transactions set forth above.

The Taxpayer claims that it structured the transaction in the manner described above to avoid sales tax liability. That is, according to the Taxpayer, "bulk sale" rules provide an exclusion from sales tax for the sale of tangible personal property to . Because and do not have similar rules, needed to contribute the and Restaurants to and then sell its partnership interest to in order to eliminate any sales tax exposure in those states. The Taxpayer claims that federal and state income tax liabilities were not adversely affected.

III. TRANSACTIONS AT ISSUE

Disposition of [redacted] and [redacted] Restaurants

Upon the formation of [redacted], [redacted] contributed $[redacted] in exchange for a general partner interest of [redacted] percent. [redacted] contributed $[redacted] in exchange for a Class A Limited Partner interest of [redacted] percent and contributed the [redacted] and [redacted] Restaurants, valued at $[redacted], in exchange for a Class B Limited Partner interest of [redacted]%. See Agreement of Limited Partnership of [redacted], a Delaware Limited Partnership (the "[redacted]"), Section 2.

Immediately following the formation of [redacted], [redacted] sold its [redacted]% Class B Limited Partner interest to [redacted] for a $[redacted] promissory note. See Partnership Interest Purchase Agreement, Article II. The promissory note bears interest at [redacted] percent per annum and requires monthly payments of $[redacted], together with a final payment of all unpaid principal and interest after [redacted] years.[3] The promissory note is secured by any limited partnership interests owned by [redacted].

Pursuant to the [redacted] Agreement, [redacted] must make distributions of "distributable cash" on a regular basis but no less frequently than quarterly in the following order and priority:

> (a) First, to the Class B Limited Partner until the Class B Limited Partner has received distributions . . . equal to the accrued and unpaid Preferred Return.
>
> (b) Second, to the Class B Limited Partner until the distributions . . . equal the Class B Limited Partner's unpaid Capital Distributions then due.
>
> (c) Third, if the balance in the Reserve Fund is less than the amount (the "Minimum Reserve Balance") that is the lower of (i) [redacted] ($[redacted]), or (ii) the outstanding balance (including any accrued and unpaid interest) due and owing under the Promissory Note, then [redacted] percent ([redacted]%) of remaining Distributable Cash shall be deposited in the Reserve Fund until the balance standing in the Reserve Fund equals the Minimum Reserve Balance.

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[3] The file contains only an unexecuted copy of the promissory note. Therefore, the terms of the promissory note may be different than those stated.

(d) Fourth, to the Class A Limited Partner until the distributions . . . equal the accrued and unpaid Preferred Return on Additional Capital Contributions.

(e) Fifth, to the Class A Limited Partner until the Adjusted Additional Capital Contributions of the Class A Limited Partner are reduced to zero.

(f) In all other cases, Distributable Cash shall be distributed [redacted] percent ([redacted]%) to the General Partner, [redacted] ([redacted]%) to the Class A Limited Partner, and [redacted] percent ([redacted]%) to the Class B Limited Partner.

To the extent that the total distributions provided for in Sections 4.1(a) or 4.1(b) during any Fiscal Year exceed the amount of Distributable Cash, the Partnership shall withdraw cash in the amount of such excess from the Reserve Fund and shall distribute such cash in accordance with Sections 4.1(a) and 4.1(b) . . .

See [redacted] Agreement, Section 4.

The [redacted] Agreement provides the following definitions for the capitalized terms above:

1. "Distributable Cash" means the gross cash proceeds from Partnership operations less the portion thereof used to pay or establish reasonable reserves for all Partnership expenses (not including amounts deposited in the Reserve Fund), debt payments, capital improvements, replacements, and contingencies.

2. "Preferred Return" means a sum equal to [redacted] percent per annum "(or [redacted] percent ([redacted]%) per annum after the occurrence and during the continuation of an Event of Default as defined in the Loan Agreement . . . between [redacted] and [redacted]) . . . of the average daily balance of the aggregate "Adjusted Capital Contributions" of the Class B Limited Partner . . . "Adjusted Capital Contributions" means the $[redacted] capital contribution made in exchange for the Class B Limited Partner Interest . . . reduced by the amount of cash distributed to the Class B Limited Partner pursuant to sections 4.1(b) and 13.2(c) of the [redacted] Agreement.

3. "Capital Distributions" means a series of distributions to be made to the Class B Limited Partner in the amounts, and on or after the dates, set forth on Schedule 2 of the [redacted] Agreement.

4. "Reserve Fund" means funds "held in the Collateral Account that will be established in connection with that certain Reserve Fund Pledge Agreement, by and among the Partnership, the General Partner, the Class A Limited Partner, and the Bank named therein."

5. "Promissory Note" means "that certain secured promissory note . . . made in favor of the Class A Limited Partner by the General Partner in the principal amount" of $[redacted].

See [redacted] Agreement, Exhibit A, Glossary.

[redacted] apparently has made each payment required under the promissory note.

The Taxpayer reported a short-term capital gain of $[redacted] with respect to the sale of its interest in [redacted] on Schedule D, Capital Gains and Loss, attached to its [redacted] U.S. Corporation Income Tax Return, Form 1120. The Taxpayer computed the gain as follows:

Gross Sales Price	$[redacted]
Cost	[redacted]
Gain	$[redacted]

The cost identified equals [redacted] percent of the cost for the [redacted] and [redacted] Restaurants.

Disposition of [redacted] Restaurants

On [redacted], the same day as the formation of [redacted], [redacted] and [redacted] entered into a Asset Purchase Agreement, pursuant to which [redacted] sold the [redacted] Restaurants to [redacted] for a promissory note of $[redacted]. The note bore interest at a rate of [redacted] percent per annum and provided for a schedule of payments.

[redacted] apparently did not make any payments on the $[redacted] promissory note. The Taxpayer states that it became clear that [redacted] would not be able to meet its obligations under the note and that the note was worthless. As a consequence, the Taxpayer states that a decision was made to find a buyer for the [redacted] Restaurants. See letter dated [redacted].

On , sold the Restaurants to , ("") for $ plus percent of gross sales from the restaurants opened and operated at the Restaurants sites.

The Service states that, at the time acquired the Restaurants, it had begun negotiating with for their sale. We were unable to locate the document to which the Service refers. The index of closing documents for the sale of the Restaurants to shows only a "Non-Disclosure and Confidentiality Agreement" dated and a "Letter of Intent" dated . Both dates occur after , the date of the Letter of Intent between the Taxpayer and , and , the date of the Asset Purchase Agreement between and . We did, however, find a note with respect to a telephone conversation between the Service and , the director of real estate for . According to , received a call seeking interest in the Restaurants in or . recalls speaking with [4] chief operating officer of , and , vice-president of the Taxpayer. By this time, and had executed the Asset Purchase Agreement.

With the sale of the Restaurants, had no means to make payments on the $ promissory note. The Taxpayer contends that the note was worthless by the end of . The Taxpayer then wrote off the note in . To reflect the write-off, the Taxpayer reduced the original asset sale price from $ to zero.

The Taxpayer reported an ordinary loss of $ with respect to the sale of the to on Form 4797, Sales of Business Property, attached to its Form 1120. The Taxpayer computed the loss as follows:

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[4] apparently worked for the Taxpayer or prior to left the employ of the Taxpayer upon the closing of the transactions to continue with as chief operating officer.

Gross Sales Price		
Equipment		
Signs		
Leasehold Equipment		
Leasehold	$ [redacted]	
Total		$ [redacted]
Adjusted Basis		
Depreciation		
Equipment	[redacted]	
Signs		
Leasehold Equipment		
Leasehold		
Total		$ [redacted]
Cost		
Equipment	[redacted]	
Signs		
Leasehold Equipment		
Leasehold		
Total	[redacted]	
Total		[redacted]
Gain or (Loss)		($ [redacted])

[redacted] reported an ordinary loss of $[redacted] with respect to the sale of the [redacted] Restaurants to [redacted] on Form 4797, Sales of Business Property, attached to its [redacted] U.S. Partnership Return of Income, Form 1065. [redacted] computed the loss as follows:

Gross Sales Price	$ [redacted]
Cost	[redacted]
Gain or (Loss)	($ [redacted])

On Form 8594, Asset Acquisition Statement, attached to its [redacted] form 1065, [redacted] identified the total purchase price of the [redacted] Restaurants as $[redacted]. In addition, [redacted] reported income of $[redacted] from "debt forgiveness."

On [redacted], [redacted] and [redacted] entered into (1) a Dissolution Agreement of [redacted] ("Dissolution Agreement") and (2) a Termination Agreement. Pursuant to these agreements, [redacted] canceled the $[redacted] promissory note, and [redacted] assigned its rights in the [redacted] percent payment by [redacted] to [redacted]

DISCUSSION

I. DISPOSITION OF [redacted] AND [redacted] RESTAURANTS

As a general rule, neither a partnership nor any of its partners recognizes gain or loss on the contribution of property to the partnership in exchange for an interest in the partnership. I.R.C.§ 721(a). The general rule, however, does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner. Treas. Reg. § 1.721-1(a).

> Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. . . . Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721.

Id.

A transaction shall be considered as occurring between the partnership and one who is not a partner, if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership. I.R.C. § 707(a)(1). A partner is not acting in his capacity as a member of a partnership in the following situation:

1. the partner directly or indirectly transfers money or other property to the partnership;
2. the partner receives a related direct or indirect transfer of money or other property from the partnership; and
3. the transfers , when viewed together, are properly characterized as a sale or exchange of property.

I.R.C. § 707(a)(2)(B). The transaction described above constitutes a sale of property, in whole or in part, by the partner to the partnership only if based on all of the facts and circumstances,

1. the transfer of money or other consideration would not have been made but for the transfer of property; and
2. in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Treas. Reg. § 1.707-3(b)(1).

Caution

Before going further, we must advise you that generally, items relating to the following transactions, "to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner" are partnership items as defined in I.R.C. § 6231(a)(3): (1) contributions to a partnership, (2) distributions from a partnership, and (3) transactions to which I.R.C. § 707(a) applies. Treas. Reg. § 301.6231(a)(3)-1(a)(4). For purposes if its books and records, the partnership needs to determine:

1. the amount transferred from the partnership to a partner or from a partner to the partnership in any transaction to which I.R.C. § 707(a) applies;
2. the character of such an amount; and
3. the percentage of the capital interests and profits interests in the partnership owned by each partner.

Treas. Reg. § 301.6231(a)(3)-1(c)(4).

> To the extent that a determination of an item relating to a transaction to which section 707(a) applies can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that items is not a partnership item. An example of such other information is the cost to the partner of goods sold to the partnership.

Id. As such, the items identified above must be determined at the partnership level. I.R.C. § 6221. And the Service should open a TEFRA partnership proceeding with respect to [redacted].

Application to Facts

In this case, [redacted] contributed the [redacted] and [redacted] Restaurants to [redacted] in exchange for a [redacted]% Class B Limited Partner interest. Immediately thereafter, [redacted] sold its Class B Limited Partner interest to [redacted] for $[redacted].

The transaction, however, resembles, at least in part, a sale of the [redacted] and [redacted] Restaurants to [redacted] for the following reasons:

1. According to the Letter of Intent, the parties intended for to sell percent of the and Restaurants to .
2. According to the minutes of the Taxpayer's board of directors, the transactions involved, in essence, "the sale of a percent interest in the [Taxpayer's] restaurants operation to affiliates of [ ] for $ in notes."[5]
3. makes an indirect transfer of money to .
   a. Although is the maker of the $ promissory note, apparently bears the burden of making the requisite payments on the promissory note.
   b. as the Class B Limited Partner is entitled, in all events, to distributions (called preferred return) equal to percent per annum of the outstanding balance on the $ promissory note.
   c. as the Class B Limited Partner is entitled, in all events, to distributions equal to amounts set forth in a schedule attached to the Agreement.
   d. The distributions coincide in time with the payments required by the promissory note, including a substantial distribution payable at the time the balloon payment under the promissory note is due.

The transaction, therefore, meets all of the requirements of I.R.C. § 707(a)(2)(B).

We recommend, however, that (b)(5)(AC)

1. (b)(5)(AC) ;
2. (b)(5)(AC) ;
3. (b)(5)(AC) ;
4. (b)(5)(AC) ;
5. (b)(5)(AC) ; and
6. (b)(5)(AC) .

[5] The "transactions" referred to in this statement include (1) the contribution of the and Restaurants to and the subsequent sale of the limited partnership interest in to and (2) the sale of the Restaurants to .

These items, if consistent with the terms of the [redacted] Agreement and the promissory note, should establish that [redacted] made indirect transfers of money to [redacted]

The question then becomes whether the transaction should be treated solely as a sale or as a part sale, part contribution. If the transaction is treated solely as a sale, the transaction would result in gain calculated as follows:

Sales Price	$ [redacted]
Plus Liabilities Relieved, if any[6]	?
Less Adjusted Basis	([redacted])
Gain	$ [redacted]

This gain is the same as that reported by the Taxpayer on its [redacted] Form 1120.

The Service, however, would like to treat the transaction as a contribution of [redacted] percent of the [redacted] and [redacted] Restaurants in exchange for a [redacted] percent interest in [redacted] and a sale of [redacted] percent of the [redacted] and [redacted] Restaurants for a promissory note. If the transaction is treated in this fashion, the transaction would result in gain calculated as follows:

Sales Price	$ [redacted]
Plus Liabilities Relieved, if any	?
Less Adjusted Basis	([redacted])[7]
([redacted] percent of $[redacted])	
Gain	$ [redacted]

This gain is the gain proposed by the Service in its examination.

We find several facts that support treating the transaction solely as a sale, as well as several facts that support treating the transaction as a part-sale, part-contribution. We believe the following facts support treating the transaction solely as a sale:

1. In the [redacted] Agreement, the parties set the gross value of all of the assets of the [redacted] and [redacted] Restaurants at $[redacted] See

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[6] *The liabilities relieved would equal* [redacted] *percent of liabilities associated with the* [redacted] *and* [redacted] Restaurants.

[7] In its analysis, the Service reduced the Taxpayer's adjusted basis of $[redacted] by $[redacted], the cost of certain intangibles, before multiplying by [redacted] percent. Intangibles are not property used in a trade or business as defined by I.R.C. § 1231(b). The gain resulting from this analysis is $[redacted]. For simplicity, we did not subtract $[redacted] from the Taxpayer's adjusted basis.

[redacted] Agreement, Section 2.2(b); see also [redacted] Agreement, Exhibit B (Contribution Agreement), Section 1.7.

2. If the contribution of the [redacted] and [redacted] Restaurants is disregarded, the contributions of cash upon the formation reflect the partners' interests in [redacted]. Specifically, [redacted] contributed $[redacted] and holds a [redacted] percent interest, and [redacted] contributed $[redacted] and holds a [redacted] percent interest. (See below for another interpretation.)

We believe that the following facts support treating the transaction as a part sale, part contribution.

1. According to the Letter of Intent dated [redacted], the parties intended for [redacted] to sell [redacted] percent of the [redacted] and [redacted] Restaurants to [redacted].
2. According to the minutes of the Taxpayer's board of directors, the transactions involved, in essence, "the sale of a [redacted] percent interest in the [Taxpayer's] [redacted] restaurants operation to affiliates of [redacted] for $[redacted] in notes."
3. The contributions of cash are disproportionate and do not correspond with the interests received in exchange for such contributions. Specifically, [redacted] contributed $[redacted] in exchange for a [redacted] percent interest, while [redacted] *contributed* $[redacted] *in exchange for a 1 percent interest.* To give economic substance to the contributions, it is logical to assume that [redacted] contributed $[redacted] plus a portion of the assets of the [redacted] and [redacted] Restaurants for the [redacted] percent interest.

To resolve this issue, we recommend that the Service obtain the following information:

1. (b)(5)(AC) [redacted]
2. (b)(5)(AC) [redacted]
3. (b)(5)(AC) [redacted]

This information should establish whether the agreed value of $[redacted] represents the full value of the [redacted] and [redacted] Restaurants or a portion thereof.[8]

[redacted](b)(5)(AC)[redacted][9]

II. DISPOSITION OF THE [redacted] RESTAURANTS

In this case, [redacted] sold the [redacted] Restaurants to [redacted] in exchange for a promissory note of $[redacted]. Shortly thereafter, [redacted] sold the [redacted] Restaurants to [redacted] for $[redacted], and [redacted] canceled the promissory note.

Approach 1 – Sale of [redacted] percent of the [redacted] Restaurants

The Service would like to treat the sale of the [redacted] Restaurants as a sale of [redacted] percent of the [redacted] Restaurants and as a contribution of [redacted] percent of the [redacted] Restaurants. The Services faces problems similar to those described above. Specifically, the transaction looks like a sale of all of the assets of the [redacted] Restaurants because:

1. The Asset Purchase Agreement defines the assets purchased by [redacted] to be "all of Seller's right, title and interest in and to all tangible and intangible properties, assets and rights which are used by Seller in connection with or otherwise useful in, or necessary or desirable for, the operation of the Restaurants . . ." See Asset Purchase Agreement, Section 1.59.
2. The contributions of cash upon the formation reflect the partners' interests in [redacted]. Specifically, [redacted] contributed $[redacted] and holds a [redacted] percent interest, and [redacted] contributed $[redacted] and holds a [redacted] percent interest.

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[8] See Jacobson v. Commissioner, 96 T.C. 577 (1991). This Court concludes that the transaction involved a part contribution of the property to the partnership and a part sale of the property to the other partner. Although I.R.C. § 707(a)(2)(B) did not apply to the facts of Jacobson, the analysis regarding how the Court reached its conclusion is helpful to this case.

[9] [redacted](b)(5)(AC)[redacted]

The only support for treating the transaction as a sale of [redacted] percent of the [redacted] Restaurants is the intent of the parties as evidenced by the Letter of Intent and the minutes of the Taxpayer's board of directors dated [redacted].

We recommend that the Service obtain the information identified above with respect to the disposition of the [redacted] and [redacted] Restaurants.

(b)(5)(AC) [redacted]

Approach 2 – Deduction for Bad Debt

The Service also could attack the Taxpayer's method of reporting of the sale of the [redacted] Restaurants. The Taxpayer did not report the sales price as $[redacted] Instead, it reduced the original sales price by $[redacted] to reflect the cancellation of the promissory note.

We do not believe that this is a proper reporting of the transactions. The Taxpayer should have reported the sales price as $[redacted] and reported the cancellation of the promissory note as a bad debt. Admittedly, reporting the transaction in this fashion leads to the same result as the reporting by the Taxpayer on its [redacted] Form 1120. However, it leads to the same result only if the Service accepts that the promissory note was worthless as of [redacted]

(b)(5)(AC) [redacted]

Approach 3 – Sale of the [redacted] Restaurants by [redacted] Directly to [redacted]

The Service has suggested another approach, using the substance-over-form doctrine and/or the step-transaction doctrine to treat [redacted] as having sold the [redacted] Restaurants directly to [redacted] for $[redacted]. The Service argues that [redacted] had begun negotiations with [redacted] for the sale of the [redacted] Restaurants prior to the time at which it sold the [redacted] Restaurants to [redacted].

(b)(5)(AC) [redacted]

(b)(5)(AC)

	Sale to (b)(5)(AC)	Sale to (b)(5)(AC
Sales Price	$ (b)(5)(AC)	$ (b)(5)(AC)
Basis		
Loss	($)	($)

(b)(5)(AC)

(b)(5)(AC)

Approach 4 – Contribution of the Restaurants to

The Service potentially could use substance over form to treat the transfer of the Restaurants to as a contribution to capital. By doing so, the Service could shift the loss to , the year of 's dissolution and could recharacterize the loss as capital.

In applying substance over form, the Service would attack the validity of the promissory note. First, apparently did not make any of payments on the note. Second, payment on the promissory depended on the success of the 's operations.

> [P]rincipal and interest shall be due and payable in arrears on the fifteenth day of each month in monthly installments equal to the lesser of (a) $ (the "Fixed Payment") and (b) [ ]'s Net Income received during the previous calendar month (the "Cash Flow Payment") . . . In the event that the undersigned pays the Cash Flow Payment in any month, then the Fixed Payment for the immediately succeeding month shall be increased by the amount of the excess of $ over the Cash Flow Payment actually paid for such month.

See Promissory Note, Section 2(b). Finally, canceled the promissory note only or months after the sale.[10]

Having said that, however, (b)(5)(AC)

[10] For a cases in which the court found a contribution of property instead of a sale of property, see Oliver v. Commissioner, 13 TCM 67 (1954) and Castle Heights, Inc. v. United States, 242 F.Supp. 350, 65-1 USTC ¶ 9483 (ED Tenn. 1965).

(b)(5)(AC) [redacted]

(b)(5)(AC) [redacted].

If you have any questions, please call me at [redacted]

[redacted]
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By: /S/ [redacted]
Attorney

cc: ARC (TL)